

IT IS WITH A SENSE OF PRIDE AND ACCOMPLISHMENT THAT, ON BEHALF OF THE PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION (PERAC), I PROVIDE YOU WITH THIS *2002 Annual Report*. This document outlines the activities of the 106 retirement systems and 1 investment fund that are responsible for providing pension benefits to public employees, retirees, and their survivors across the state. More than 350,000 men, women and children rely on these benefits for their well-being, and it is the solemn duty of all of us involved in the administration or oversight of the pension system to ensure that their interests are protected. The members of our Commission, in all of their deliberations, are ever mindful of that responsibility.

#### EDUCATIONAL INSTITUTE

During the course of its existence, PERAC has emphasized the importance of education as an integral part of its mission. In 2002, that commitment reached a milestone with the Educational Institute on Public Pension Administration held at the University of Massachusetts, July 28–31. After more than a year of planning and intense preparation by PERAC staff and guest presenters, a comprehensive and informative program was made available to the 203 retirement board members and administrators in attendance. Topics included: Retirement Basics, Introduction to Accounting, Monthly Closing, Internal Control Review, Child

Support Enforcement, Benefit Calculations, Public Records and Records Retention, Avoiding Audit Findings, Pre-Retirement Counseling, PERAC Web Page, Disability Retirement, Understanding an Actuarial Valuation Report, Fundamentals



Joseph E. Connarton  
*Executive Director*

of Asset Allocation, Evaluation of a Money Manager, Annual Statement of Earned Income (91A) Reporting, Comprehensive Medical Evaluation/Return to Service (CME/RTS), Competitive Bid Process, Local Experience Study, Fiduciary Liability, Tax Issues, The Legislative Process, and Securities Lending and Commission Recapture. Attendees found that these topics were relevant, well thought out, and presented in an informative manner. Over 90% of attendees surveyed found PERAC staff to have earned a rating of excellent in terms of professionalism, helpfulness, and attitude. The response of board members and administrators was

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## LETTER *from the* EXECUTIVE DIRECTOR

summed up in the remarks of one participant who observed, "Congratulations on a job well done! The PERAC staff were very professional, helpful, and courteous."

The Commission has already commenced planning for the 2004 Educational Institute, and details

managers listing (p.65), the long-term return of our systems has held up very well and, in most cases, exceeds the actuarial assumed rate of return by a comfortable margin. As expected, these long-term returns have been reduced by the experience of the last three years. However, that

the assumed rate of 8.25%. The negative performance of the last few years is no surprise in the sense that the assumption expected the annual performance to bring the long-term performance more in line with the 8.25% assumption.

#### ISSUES OF NOTE

It seems that no year would be complete without our pension system being the subject of controversy, and 2002 was no exception. In the spring, a series of reports focused on the Termination Allowance under Chapter 32, Section 10. That provision grants a benefit of  $\frac{1}{3}$  of compensation plus annuity to retirement system members that have achieved 20 years of service and who have involuntarily lost their position. The focus of attention was on the cases of several prominent public officials. Several boards conducted reviews of these cases, and legislation was adopted that provided that PERAC would be responsible for the review of retirement board awards of termination benefits in the same manner as the Commission reviews disability benefit decisions.

Later in the year, the Commission issued an Order to boards seeking information about the enforcement of Chapter 32, Section 15. That section provides that, upon conviction of certain criminal offenses, a member forfeits his or her right to a retirement allowance. A very limited number of cases had achieved a level of public notoriety. I am pleased to

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will be provided as soon as they become available.

#### INVESTMENT PERFORMANCE

The 2002 investment returns continued to be disappointing due to negative overall market conditions. It is, however, noteworthy that the statewide composite return of our systems compared well with various nationwide measures. That average was -8.98%. The median Massachusetts return was -8.76% as compared to the median return for pension funds in TUCS (Trust Universe Comparison Service) which was -9.01%.

In each annual report since the Commission's creation, the central message of the investment commentary has been the fact that pension funds are long-term investors, and therefore, long-term performance is far more important than short-term performance. As outlined in the table preceding the

experience actually confirms the validity of the actuarial investment assumption as actual returns move closer to the 8.00%–8.50% assumption. As an illustration, the State and Teachers Board returns for the period from 1985–1999 were 13.36% and 13.38%, respectively. The returns for the 1985–2002 period were 10.00% and 10.02%, respectively. The actuarial assumption used in conducting the actuarial valuation of the Commonwealth's Total Pension Obligation is 8.25%. Thus, in spite of the experience of the last three years, the long-term investment return on the Commonwealth's pension assets remains comfortably above the assumption. In fact, based on that assumption, returns between now and the end of the 20-year period the statute allows for amortization of the unfunded liability are expected to reduce the return to

report that the conclusion of our analysis of the board responses to the Order is that, in general, boards have been vigilant in fulfilling their responsibilities under the law. However, it appears that there is a lack of a formalized mechanism to ensure that the proper authorities notify retirement boards of these cases. PERAC is working to devise a method that will improve the lines of communication in this regard.

In the fall, the Commission continued its campaign against pension fraud through a public information initiative formed around the development of a new pension fraud poster and its dissemination throughout the Commonwealth. Although all objective observers agree that such fraud is rare, it is important that we maintain our efforts to uncover and prosecute such instances. We owe that to the employees and retirees who have devoted their lives to public service, and through that service, earned the benefits made available under Chapter 32.

In 2002, the retirement boards once again met the intense administrative challenge of implementing local early retirement incentive programs. Across the state, more than 250 governmental units adopted the legislation that granted members an additional five years of service or age (or a combination up to a total of five years). PERAC's calculation group worked with board members and administrators to ensure a timely turnaround in the approval of calculations. This

effort resulted in the smooth and efficient granting of benefits. We are unaware of a single complaint from a member relating to the manner or speed in which a board processed his or her benefit.

#### **HEDGE FUND GUIDELINES**

In the past year, the Commission has been well aware of the serious decline in the value of the portfolios of the retirement systems. The shock of several consecutive years of negative performance in the capital markets has been reflected in investment performance of these systems. Although, as noted elsewhere, the long-term results for most Massachusetts public pension systems remain above actuarial expectations, it appears that, at least in the near future, great uncertainty exists as to the direction of the markets. With this in mind, throughout 2002, PERAC carefully considered the merits of authorizing boards to invest in so-called "Hedge Funds". Extensive research by Investment Director Robert Dennis concluded that, in spite of the unique risks inherent in these investments, their lack of correlation to the markets and goal of absolute return as well as positive performance in the recent downturn supported the establishment of a process by which boards could begin to invest in these funds. Following the expression of interest on the part of several boards, the Commission and its Investment Sub-Committee met on a number of occasions to develop guidelines that balanced the

risks involved with the potential benefits of these investments. In addition, we met with investment consultants who do business with our retirement boards to discuss not only the level of interest in "Hedge Funds", but the details of PERAC Guidelines. Ultimately, PERAC's Guidelines for Hedge Fund Investment were issued. Initially, only systems with an asset value in excess of \$250 million may seek authority to invest in these funds. Among other requirements, boards must receive PERAC approval before commencing the search for such a fund and must have a record of past compliance with the Commission's regulations and procedures. It is our belief that this action underscores the flexibility with which the Commission has approached its responsibilities in the investment area, as well as its willingness to assist the retirement boards in pursuing strategies that enhance return and manage risk, while keeping in mind that the ultimate objective of the Commission and the boards is to preserve the principal of each portfolio.

#### **EARNINGS REVIEW**

One of the major functions assigned to PERAC is the post-retirement monitoring of disability retirees. The statute places limits on the earnings that these retirees can attain, and enforcement of those limits is a duty of the Commission. Since the establishment of PERAC, we have striven to make the process of earnings

review smooth, efficient, and sensitive to the individuals that must file earning statements. This has been accomplished through the development of easy to understand forms as well as communication with the retirees explaining the purpose of the review and the process to be followed. This has

all disability retirees are in full compliance with the law and have been for a number of years. Second, PERAC has been successful in implementing the statute in a sensitive and conscientious manner as evidenced by the high rate of filing compliance.

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enabled PERAC to conduct an accurate and timely review of over 15,000 earning statement submissions each year. Some of the statistics relating to the 2001 reporting period are worth noting. Of the 15,000 retirees, only 3,795 (25%) report any earnings at all. Of that number, only 161 retirees (exclusive of Boston) report earnings in excess of the statutory limits. An additional 93 retirees did not file a statement in 2002 (for the 2001 reporting period). In the most recent period, PERAC recovered \$1,215,815 for systems as a result of earnings above the limit. An additional \$1,619,748 was recovered due to the suspension of the benefits of those who failed to file. The total amount recovered by PERAC since the program began is \$13,875,533. This experience leads to several conclusions. First, nearly

#### ACTUARIAL ACTIVITIES

One of the realities of 2002 that will continue for the foreseeable future is the budget crisis confronting the state and its municipalities. As fiscal conditions have deteriorated, the effort to preserve essential services in the face of revenue decline has led to scrutiny of all budgetary items, including pension appropriations. Unfortunately, this has, in some instances, led to pension funding schedule revisions that, although necessary in the larger context of the budget crisis, have delayed the amortization of unfunded liability. In the case of the Commonwealth, the schedule time frame has been moved from 2018 to 2023, and the amortization payment annual increase is now 4.15% rather than level. PERAC's Actuary, James Lamenza, worked with a number

of systems in 2002 to mitigate the impact of pension costs on local budgets while maintaining the actuarial integrity of the schedule. A total of fifty-three new funding schedules were approved, and twenty-eight appropriation letters were revised as part of the funding schedule process or for other reasons. Several techniques have been employed, which include: lengthening the schedule, increasing the annual amortization payment rate, adopting an actuarial value of assets, and incorporating new assumptions based on the *PERAC State and Teachers Experience Study* and the *PERAC Local Experience Study*. In 2002, PERAC and private actuaries conducted a total of 61 actuarial valuations of the retirement systems. Actuarial valuations as of 1/1/03, and revised funding schedules based on those valuations, will further challenge our ability to maintain the balance between fiscal necessity and actuarial probity. PERAC will work with retirement boards, public officials, and other interested parties in an effort to develop schedules that are responsible and responsive.

Other actuarial activities included the completion of an analysis of the new benefit structure for teachers (Retirement Plus), finalization of the *Local Experience Study*, as well as analysis of the costs associated with the State Early Retirement Incentive Program. Over 18 actuarial briefings were held with the board or staff of retirement boards, and, as always, we stand ready to meet

with boards at any time regarding these matters. PERAC also completed work on implementing the provisions of IRS Code Sections 401(a)(17) and 415. These provisions deal with limitations on benefits for highly compensated employees and thankfully, at least at this point, impact very few members and retirement systems.

#### COMMUNICATIONS

PERAC continued its ongoing publication efforts during the year. In addition to nearly 25 distinct publications prepared for the UMass Conference, numerous other items were drafted and disseminated. A second “how to” guide entitled, *How to Complete a Pooled Fund Worksheet*, was issued as part of a regular series of such materials. The *2001 Annual Report* was distributed to all boards, as well as the *Local Experience Study* that assessed the efficacy of the assumptions used in the conduct of actuarial valuations. In addition, a study of the *State Employees’ Early Retirement Incentive Program*, a delineation of *Retiree’s Rights and Responsibilities*, a *CME Physician Guide*, and *Medical Standards & Fitness Standards for Municipal Firefighters, Police Officers and State Police* were published. These specialty items supplemented our regular publications that included *PERAC Quarterly Financial Bulletins*, *PERAC Web News*, and *Actuarial Updates*.

PERAC also devoted special attention to the continued

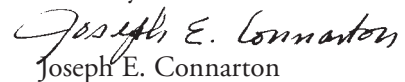
improvement of its Web page ([www.mass.gov/perac](http://www.mass.gov/perac)) with an emphasis on interactivity and ease of use. The PERAC home page was redesigned to feature a more understandable and simplified functionality. Interactivity was expanded. Now boards may use the PERAC Web page to complete pooled fund worksheets, fill out appropriation questionnaires, and calculate buy-backs. In addition, various ad hoc surveys, such as that related to the UMass Conference, were made available for completion. It is a critical goal of the Commission to expand the interactive use of the Internet, and we are exploring several new initiatives for 2003–2004. The home page continues to be an important source of information for all those involved in or interested in retirement matters. New postings included a number of job opportunities throughout the retirement boards, RFP announcements, Ethics Commission Opinions and Enforcement Actions, and numerous valuation and audit reports. We urge retirement boards to avail themselves of the opportunity to post job openings and RFP announcements on the PERAC home page for the widest possible exposure to the retirement community.

In addition to the UMass Conference, PERAC held several workshops. These included our Annual Statement classes, attended by nearly 100 administrators and staff, as well as seminars on the implementation of the Local Early

Retirement Incentive Program, attended by over 160 board members and staff.

As I write these observations, the men and women of our Armed Forces have once again been called on to bear the heavy burden of engaging in combat operations half a world away. Some have made the ultimate sacrifice and given their lives, defending the principles of democracy. Hopefully, by the time this document is published, the conflict will be over, and the men and women of the Armed Forces will have safely returned to their loved ones. May God protect them and secure their safety.

Sincerely,

  
Joseph E. Connarton  
Executive Director